MONTANA MONEY SCHOOL

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How Financial Markets Work

Financial markets are places where firms and individuals enter into contracts to buy or sell a specific product such as a stock, bond or futures contract. Buyers seek to buy at the lowest available price and sellers seek to sell at the highest available prices. Financial markets are similar to a public market where money and people come together to buy and sell products or resources. Prices for goods and services depend largely on the law of supply and demand. If the supply of a product is insufficient to meet the demand, consumers will pay more. On the other hand, if the supply outweighs the demand, the price will remain low.

Securities markets deal primarily with stocks and bonds. The primary purpose of a securities market is for businesses to acquire investment capital. A stock is an investment product that represents partial ownership of a company or corporation. The stock market represents companies that sell their shares to the public.

Markets consist of a number of "exchanges," which serve as central locations where buyers and sellers meet in person, by telephone or by computer terminal to trade stocks, bonds and other securities.

At a stock exchange, investors buy and sell stocks and bonds, either directly or through agents called brokers. Public corporations list their stocks and bonds on an exchange, known as the stock market or financial markets. Most stocks in the United States, however, are listed (traded) on just two exchanges, the New York Stock Exchange (NYSE) and the NASDAQ Stock Market. The NASDAQ is a computer-based trading system, while the NYSE is floor-based. A traditional floor-based market operates in a specific building where the investor's agent must be present to trade stocks. To buy company stock listed on the NYSE, the investor places an order through a stockbroker. The stockbroker relays the purchase to a floor trader on the exchange floor who then buys the stock.

A computer-based market, such as NASDAQ, enables investors to trade stocks through a telecommunications network. They access the market on desktop terminals while a mainframe computer processes the trade.

The stock market is a primary barometer of the economic health of a nation and its economy since consumer and industrial spending activities drive corporate earnings, which in turn drive stock prices.

In any given period, the stock market will rise and fall, and each time, individual stock prices are affected. When a stock rises and falls more than the average stock price, it is considered volatile. When stock markets rise, which is known as a bull market, the country generally is experiencing a period of economic growth. When the stock market declines, the country may be experiencing a downturn in the economy or low investor confidence. This is known as a bear market.

Five main factors that affect what will happen to stock and bond values are investor actions, business conditions, government actions, economic indicators, and international events and conditions.

DOW JONES INDUSTRIAL AVERAGE

The Dow Jones Industrial Average is the oldest continuous barometer of the U.S. stock market. In 1884, a journalist named Charles H. Dow invented a way to follow the overall stock market on a daily basis. He put together a list of 12 important stocks and at the end of each trading session, added up all the closing prices and divided by 12. He published the average in a news bulletin. Over time, it became known as the Dow Jones Industrial Average (Jones was Dow's partner) and it has served as the financial yardstick of stocks for more than a century. Today, when people ask, "How is the market doing?" they often are talking about the Dow Jones Industrial Average.

As the economy expanded, more companies were added. The Dow stocks are representative of the broad market and American industry, are considered major players in their industries and are widely held by investors. Some companies included in the Dow are Coca-Cola, General Motors, IBM, McDonalds, Microsoft, Wal-Mart and Walt Disney. The Dow Jones Web site can be accessed at www.dowjones.com/corp.index.html

DECIPHERING THE STOCK TABLES

Millions of dollars are traded every day on the NASDAQ, NYSE and other exchanges in the United States. Market prices often rise or fall on a minute-by-minute basis (market volatility) due to business conditions, investor activity and government action. When the market closes at 4 p.m. EST, market trading stops. The closing price of each stock is quoted until the market opens the next business day.

Stock tables summarizing the previous day's trading activity are published in newspapers and announced on television and radio. Each publication displays their stock table a little differently. The following format is used in the Wall Street Journal.

- The name of the stock appears in the second column from the left under "stock."
- In the first two columns, "365-Day High-Low," there are two numbers, the highest price and the lowest price paid for the stock in the past 12 months.
- The four columns to the far right, "High, Low, Last and Chg" offer the highest and lowest prices charged for the stock yesterday, the last price charged and the change from the previous day's closing price.
- Directly to the right of the word "Stock," is "Div," which stands for dividend. Dividends are payments a company makes to investors.
- "Yld%" (Yield) allows a comparison to the yield from a saving account or bond.
- To the right of "Yld%" is "P/E," which stands for "price to earnings ratio." This is the price of a stock divided by the company's annual earnings. Investors use this to evaluate the stock's price.
- The "Sales" column refers to the number of shares traded the previous day. This number multiplied by 100 provides the number of shares that traded hands.

ONLINE INVESTING

See the State Auditor's brochure ***"Online Investing Tips"*** for information on and the risks associated with online investing. It is available on our Web site at http://sao.state.mt.us or by calling 1-800-332-6148 or 444-2040.